LIBRARY

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute and Regulations involved	2
Statement	2
Argument	5
Conclusion	8
Appendix	9

CITATIONS

Cases:

Bondy v. *Commissioner*, 269 F. 2d 163	8
Coady v. *Commissioner*, 33 T. C. 771, affirmed per curiam, 289 F. 2d 190	6
Commissioner v. *Duberstein*, 363 U. S. 278	8
Parshelsky, Estate of v. *Commissioner*, 34 T.C. 946, reversed and remanded, May 3, 1962 (C.A. 2d)	8
Wilkins v. *United States*, 188 F. Supp. 91	8

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 355	4, 5, 6, 7, 8, 9
Sec. 355(a)	9
Sec. 355(b)	5, 10

Miscellaneous:

3 Mertens, *Law of Federal Income Taxation* (1957):	
Sec. 20.100	5
Sec. 20.103	5
Rev. Rul. 61-198, 1961-45 Int. Rev. Bull. 6	6
Treasury Regulations on Income Tax (1954 Code):	
Sec. 1.355-1(a)	6, 10
Sec. 1.355-1(b)	7, 11
Sec. 1.355-1(c)	6, 7, 11
Sec. 1.355-1(d)	6, 7, 12

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 880

THEODORE F. APPLEBY and MARIE W. APPLEBY,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 59a-76a;[1] Pet. App. 15-31) are reported at 35 T. C. 755. The *per curiam* opinion of the court of appeals (Pet. 32-33) is reported at 296 F. 2d 925.

---

[1] Record references are to the joint appendix in the court of appeals.

JURISDICTION

The judgment of the court of appeals was entered on January 10, 1962 (Pet. App. 33). A petition for rehearing was denied on January 30, 1962 (Pet. 2). The petition for a writ of certiorari was filed on April 17, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the business conducted by a newly-formed subsidiary was one that had been actively conducted by the parent for five years so as to make the distribution of the subsidiary's stock to the stockholders of the parent nontaxable under Section 355 of the Internal Revenue Code of 1954.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Section 355 of the Internal Revenue Code of 1954 and Section 1.355-1 of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 9-13.

STATEMENT

Taxpayers are husband and wife who filed a joint income tax return for the year 1955. They own all the stock of T. Frank Appleby Agency, Inc., a New Jersey corporation (hereinafter referred to as Agency). (R. 60a-61a; Pet. App. 16.)

In 1932, Agency was incorporated and took over the real estate and insurance brokerage business theretofore conducted by the Applebys (father and son). The business was housed in a building on Main Street in Asbury Park, New Jersey. During the years 1950 through 1954, Agency occupied about 50 per cent of the floor space of the building, and the remaining space was rented. Agency executed the leases to the tenants, had repairs made to the building, looked after tax matters and watched the occupancy and use of the property so that insurance rates would not be affected. (R. 61a-62a, 70a; Pet. App. 16-17, 26.)

The fair rental value of the property in its entirety is about $12,000 per year (R. 64a; Pet. App. 19). For the years 1950 through 1954, Agency received about $3,700 per year for the rented portion of the property (R. 64a-65a; Pet. App. 20-21). During the same period, the operating expenses of the property amounted to about $8,000 per year (R. 66a-67a; Pet. App. 22-23). No records as to net income from rentals were maintained (R. 71a; Pet. App. 27). Agency's gross income from rentals was but a small fraction of its gross income from all sources (R. 66a; Pet. App. 22).

At a meeting of Agency's Board of Directors, held on November 22, 1954, a plan for reorganization was approved so as to segregate the company's real property interests from its brokerage activities. Pursuant to that plan, the Appleby Building Corporation (hereinafter referred to as Building) was incorporated under the law of New Jersey in January, 1955.

The Main Street property was transferred by Agency to Building in exchange for the latter's entire stock issue (750 shares). The stock was immediately distributed to taxpayers (the sole stockholders of Agency) in proportion to their holdings. The fair market value of the stock so distributed was $50,400. (R. 62a, 71a; Pet. App. 17-18, 27.)

On January 2, 1955, Building leased the property back to Agency for 10 years at a rent of $12,000 per annum. This amount was to be reduced by the amount of rent collected from the other tenants of the premises. (R. 63a-64a, 71a; Pet. App. 18-19, 27.)

After the reorganization, Agency continued its brokerage business and also continued to occupy 50 per cent of the floor space of the building. There were four other tenants. Building set up its own bank account, its own books, and managed the property. Building conducted its business from the office of Agency, and the only employees of Building were also employees of Agency. In December 1955, Building acquired additional property in Asbury Park which it rented. (R. 62a, 64a; Pet. App. 18, 19-20.)

The undistributed profits of Agency as of December 31, 1955, were more than $72,000 (R. 68a; Pet. 24).

The Commissioner determined that the distribution of the Building stock to the taxpayers did not qualify as a tax-free distribution under Section 355 of the Internal Revenue Code of 1954 and was, therefore, taxable to them as a dividend (R. 60a; Pet. App. 15-16). The Tax Court sustained the Commisioner, but the value of the distribution was reduced by stipula-

tion (R. 15a) and thus decreased the amount of the deficiency as determined by the Tax Court (R. 76a; Pet. App. 31-32). The court of appeals affirmed (Pet. 33).

ARGUMENT

1. Section 355 of the 1954 Internal Revenue Code (App., *infra*, pp. 9-10) provides for the nonrecognition of gain or loss to stockholders upon receipt by them of certain distributions of stock in a controlled corporation. The decision in the present case turns upon whether the taxpayers met the requirements of Section 355(b) as to active businesses. The statute provides that both the business retained by the distributing company and the business of the corporation whose stock is distributed must have been actively conducted for the five years preceding the distribution. This requirement is a safeguard against the possibility of tax avoidance inherent in giving recognition to the "spin-off" of corporate assets as a non-taxable distribution. See 3 Mertens, *Law of Federal Income Taxation*, Secs. 20.100, 20.103 (1957).

Implementing this statute, the applicable regulation (Treasury Regulations on Income Tax (1954 Code), Sec. 1.355-1 (App., *infra*, pp. 10-13)) provides that there must be a separation of two or more existing businesses which have been in active operation for at least five years. The regulation further provides that in order to constitute a separate business which can be spun off tax-free, the business must consist of a group of activities which are independently producing

income and are not merely incidental to the business of the distributing corporation.

In the present case, the Tax Court, after carefully reviewing the facts, concluded (R. 68a, 75a; Pet. App. 24, 31) that Agency's rental activities were only incidental to the operation of its brokerage business and did not constitute an independently active business which could be spun off as a tax-free distribution under Section 355 of the Code (see Sec. 1.355-1(c) and (d), Example (4), of the Regulations, App., *infra*, pp. 11-13).

2. Taxpayers are in error in asserting (Pet. 5) a direct conflict between the present case and *Coady* v. *Commissioner*, 33 T.C. 771, affirmed *per curiam*, 289 F. 2d 490 (C.A. 6th). Although, in *Coady*, the courts invalidated that portion of the Regulations providing that Section 355 of the 1954 Code does not apply to the division of a single business (Sec. 1.355-1(a) of the Regulations, App., *infra*, p. 11),[2] in the present case the Tax Court properly distinguished *Coady* (R. 72a; Pet. App. 28) on the ground that here there is no question of a single business being divided

---

[2] The reason behind Section 1.355-1(a) of the Regulations is that a division of a single business results in two new businesses neither of which had been operated as an independent business in the past. The Tax Court and the Sixth Circuit thought that this reasoning was extreme and that the resulting businesses were merely continuations of the former single business and did not constitute new ventures. In the absence of a conflict, certiorari was not requested in the *Coady* case. The decision is not being followed as a precedent by the Internal Revenue Service which has noted its nonacquiescence. See Rev. Rul. 61-198, 1961-45 Int. Rev. Bull. 6.

into two businesses (with equal division of all assets, operating and non-operating); but rather the question whether the original corporation (Agency) was engaged in two separate businesses which could be separated on the basis of their independent operations. The Tax Court properly held (R. 75a; Pet. App. 31), that only one business was being actively conducted prior to the distribution, which was the brokerage business. In this respect, taxpayers are incorrect in intimating (Pet. 8) that Agency was engaged in the active conduct of the real estate business prior to the distribution. The renting activities of Agency were merely incidental to the principal business of brokerage and no real estate business existed as such until after the distribution was effectuated.[3]

Essentially the question whether Agency conducted two separate businesses was a question of fact for

---

[3] While *Coady* held that Section 355 may apply to the division of a single business into two businesses, it clearly did not hold (as taxpayers assume (Pet. 6)) that all "activities" incidental to a single business carried on by the distributing corporation—irrespective of their nature and scope—must be treated as a separate "business" merely because the activities are thereafter separately carried on by the new (controlled) corporation.

Nor did the courts below hold (as taxpayers further assume (Pet. 7)) that rental activities can never amount to the active conduct of a separate business within the meaning of Section 355; on the contrary, as is plain from its opinion (R. 75a; Pet. App. 30-31), the Tax Court found that the realty activities carried on by Agency and taken over by Building were too minor and incidental to constitute a separate active business within the purview of that section and the applicable Treasury Regulations (see Sec. 355 (b), App., *infra*, p. 10; Sec. 1.355-1 (c) (2) and (d), Example (4), of Treasury Regulations, App., *infra*, pp. 12, 13.

the trial court, which that court resolved against the taxpayers. As noted by the court of appeals (Pet. App. 33), there is no adequate basis for saying that the decision of the Tax Court on this factual issue is wrong. The court of appeals performed its duty properly (see *Commissioner* v. *Duberstein*, 363 U. S. 278, 290-292). Taxpayers' objections and criticisms (Pet. 10-14) are therefore without merit.[1]

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

HARRY BAUM,
L. W. POST,
Attorneys.

MAY 1962.

---

[1] *Bondy* v. *Commissioner*, 269 F. 2d 463 (C. A. 4th), and *Wilkins* v. *United States*, 188 F. Supp. 91 (S.D. Ill.), referred to by taxpayers (Pet. 9), are not in point since they involved different issues and statutory provisions from the ones involved here; no question as to Section 355 of the 1954 Code was presented in those cases. See also *Estate of Parshelsky* v. *Commissioner*, 34 T.C. 946, reversed and remanded, May 3, 1962 (C.A. 2d).

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, * * *

* * * *

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

* * * *

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, * * *

* * * *

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * *

(b) *Requirements as to Active Business.*—

(1) *In general.* Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business * * *.

* * * * *

(2) *Definition.* — For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, * * *

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution * * *.

* * * * *

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.355-1. *Distribution of Stock and Securities of Controlled Corporation*—(a) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation of existing businesses which have been in active operation for at least five years, and which, in general, have been

owned for at least five years by the corporation making the distribution of stock or of stock and securities. Section 355 does not apply to the division of a single business. For the purpose of section 355, stock rights or stock warrants are not included in the term "stock and securities."

(b) *Types of separations.* Section 355 is concerned with two general types of separations of businesses. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a new corporation which stock was received in exchange for the assets of a business previously operated by the distributing corporation. In both cases, this section contemplates the continued operation of the businesses existing prior to the separation.

(c) *Active business.* Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355 (b) (1) and (2). Without regard to such rules, for purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

(1) The holding for investment purposes of stock, securities, land or other property,

including casual sales thereof (whether or not the proceeds of such sales are reinvested),

(2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

(d) *Examples.* The following examples illustrate the application of the rules described in paragraph (c) of this section:

Example (1). Corporation A is engaged in the manufacture and sale of soap and detergents and owns investment securities. It proposes to place the investment securities in a new corporation and distribute the stock of such new corporation to its shareholders. The holding of investment securities does not constitute a trade or business.

Example (2). Corporation B is engaged in the business of manufacturing and selling hats in its own factory building. It proposes to transfer the factory building to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in connection with the manufacturing of hats constitute a trade or business; but the operation of the factory building does not.

Example (3). Corporation C, a bank, owns an eleven-story downtown office building, the ground floor of which is occupied by it in the conduct of its banking business and the remaining ten floors of which it rents to various tenants. The ten floors are rented, managed and maintained by the real estate department of the bank. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. The activities in connection with banking constitute a trade or business as do also the activities in connection with the rental of the building.

Example (4). Corporation D, a bank, owns a two-story building in a suburban area, the ground floor and approximately one-half of the second floor of which is occupied by it in the conduct of its banking business. The remainder of the second floor is rented as storage space to a neighboring retail merchant. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. With respect to the rental of part of the second floor of its building, the bank is not engaged in the active conduct of a trade or business, such activity being only incidental to its banking business.

* * * *

☆ U. S. GOVERNMENT PRINTING OFFICE: 1962 839722 1330